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Economics Revision Focus: 2004

A2 Economics

Contestable Markets

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Revision Focus on Contestable Markets

A2 Syllabus Requirements:

Candidates should be able to discuss the **significance of market contestability** for the **performance** of an industry. They should be familiar with concepts, such as **sunk costs** and **hit and run competition**.

What is a contestable market?

Baumol defined contestable markets as existing where “an entrant has access to all production techniques available to the incumbents, is not prohibited from wooing the incumbent’s customers, and entry decisions can be reversed without cost.”

For a contestable market to exist there must be **low barriers to entry and exit** so that there is always the potential for new suppliers to come into a market to provide fresh competition to existing suppliers.

For a perfectly contestable market, entry into and exit out of the market must be costless

The reality is that **no market is perfectly contestable** (there are always some “**barriers to contestability**” – see your revision notes on **barriers to entry**). That said, it is also true that **virtually every market is contestable to some degree** even when it appears that the monopoly position of a dominant seller is unassailable. This can have important implications for the competitive behaviour (**conduct**) of existing firms and clearly then affects the **performance of a market** from an economic efficiency viewpoint (e.g. **allocative, productive and dynamic efficiency**)

Contestable markets and perfect competition - the differences

Contestable markets are different from perfect competitive markets. For example, it is feasible in a contestable market for **one firm** to dominate the industry, have **price-setting power** and also for firms in a market to produce a **differentiated product** both of which run counter to the assumptions behind the traditional model of perfect competition.

There are three main conditions for pure market contestability:

- Perfect information and the ability and/or the right of all suppliers to make use of the best available production technology in the market
- The freedom to market / advertise and enter a market with a competing product
- The absence of sunk costs (i.e. low barriers to exit) – this reduces the risks of coming into a market

Sunk costs – a barrier to contestability

Barriers to market contestability exist when there are **sunk costs**. These are **costs that have been committed by a business cannot be recovered once a firm has entered the industry**.

It might be easier to think of **sunk costs** as costs that are unavoidable once they have been committed at a particular moment in time – a classic example being the money that the telecoms firms committed to winning the 3rd generation mobile phone licences at auction in 2000.

When sunk costs are high, a market is more likely to produce a price and output similar to monopoly (with the risk of allocative inefficiency / market failure that follows on from this).

The Increasing Contestability of Markets

One feature of the British and European economy in recent years has been an increase in the number of markets and industries that are genuinely contestable. Several factors explain this development:

Entrepreneurial Zeal

It is often the case that markets become more competitive because of the **persistence of entrepreneurs** who simply do not accept that the existing market structure is a given. Decisions to enter markets where there are already dominant businesses with significant industry experience involve taking **risks** – but a new supplier may have the advantage of **product innovation** or a more **competitive business model** based on **different pricing strategies**.

Blueback Taxis

The London taxi-cab market has just been shaken up by the arrival of a new, heavily branded competitor. Blueback aims to become the “Starbucks” of the taxi market. What strategy is it using to enter the market?

The London taxi market is highly fragmented - i.e. supplied by numerous small operators and is largely unbranded. The objective of Blueback is to rapidly grow market share by launching a clearly branded service that will encourage taxi drivers to switch to the company.

Blueback has taken a leaf out of low-cost airline Easyjet’s strategy book with the way it has developed its new service. Blueback has one, up-front pricing policy and runs only one type of vehicle, the Fiat Multipla. Each vehicle carries the same, distinctive blue and silver livery. The drivers wear the same uniform and offer customers newspapers and mobile phone chargers as part of the onboard service. All drivers go through Blueback’s driver training programme and are licensed by the PCO. The Blueback service was developed from marketing research that asked people what they wanted from taxi hire. This covered areas such as ordering, pricing and experience of the service. The long-term objective of the company is to have a fleet of 1000 vehicles within the next few years and to be the market-leading taxi operator in London

Adapted from [Business Café](#) (February 2004)

Metro Newspapers

In a mature newspaper market, one growth story stands out. In the last five years, we have seen the rapid emergence of the Metro - a free morning newspaper targeted at urban commuters in major cities. The paid-for daily newspaper is being challenged by an increasing number of free daily newspapers worldwide. Latest distribution statistics for Metro, the leading free newspaper, show the popularity of the Metro model shows no sign of weakening.

Free distribution newspapers, like Metro, have rejected the traditional model. They have created one that relies completely on advertising revenue and establishing free distribution in and around the major public transportation systems of large cities. This has caused much concern amongst publishers of paid-for newspapers who fear the new free dailies will further erode their circulation and undermine their advertising base.

Adapted from [Business Café](#) (April 2004)

De-regulation of markets – Also known as **market liberalisation**, de-regulation involves the **opening up of markets to competition** by reducing some of the **statutory barriers to entry** that exist. Good examples of recent deregulation include the main utilities such as gas and electricity and also the liberalisation of telecommunications and postal services as part of the European Union competition initiatives.¹

In **postal services**, all EU countries must open up business and household mail delivery services so that there is at least one competing supplier to the dominant national postal service provider. The liberalisation is scheduled to be completed by 2007. Already the Royal Mail is negotiating agreements with other postal service companies to deliver their pre-sorted mail “the final mile” to consumers.

In **telecommunications**, the advent of pre-carrier selection means that there is now increasing competition for land-line telephone services. British Telecom is now facing much greater competitive pressure from Just Talk, Talk-2, Talk-Talk (Carphone Warehouse) and other providers². In March 2004, Carphone Warehouse announced that it was to offer households free local calls, challenging the dominance of BT in the fixed line market.

Competition Policy

Tougher competition laws acting against **predatory behaviour** by existing firms are designed to make markets more contestable. In both the UK and the EU this has included tougher rules against **price fixing cartels**. When market contestability is weak, there is nearly always greater scope for cartel-type behaviour by the existing firms, particularly if the market structure in which they operate comes close to an oligopoly.

The European Single Market

The development of the Single European Market has opened up the markets for member nations. A good example of this is home and car insurance and also the entry of Western European clothes retailers onto the UK high streets and shopping malls. The abolition of block-exemption for car dealerships within the EU should also help to make the retail car market more contestable in the UK in particular and may help to bring down further the prices of new cars.

Technological Change (including the e-mergence of e-commerce!)

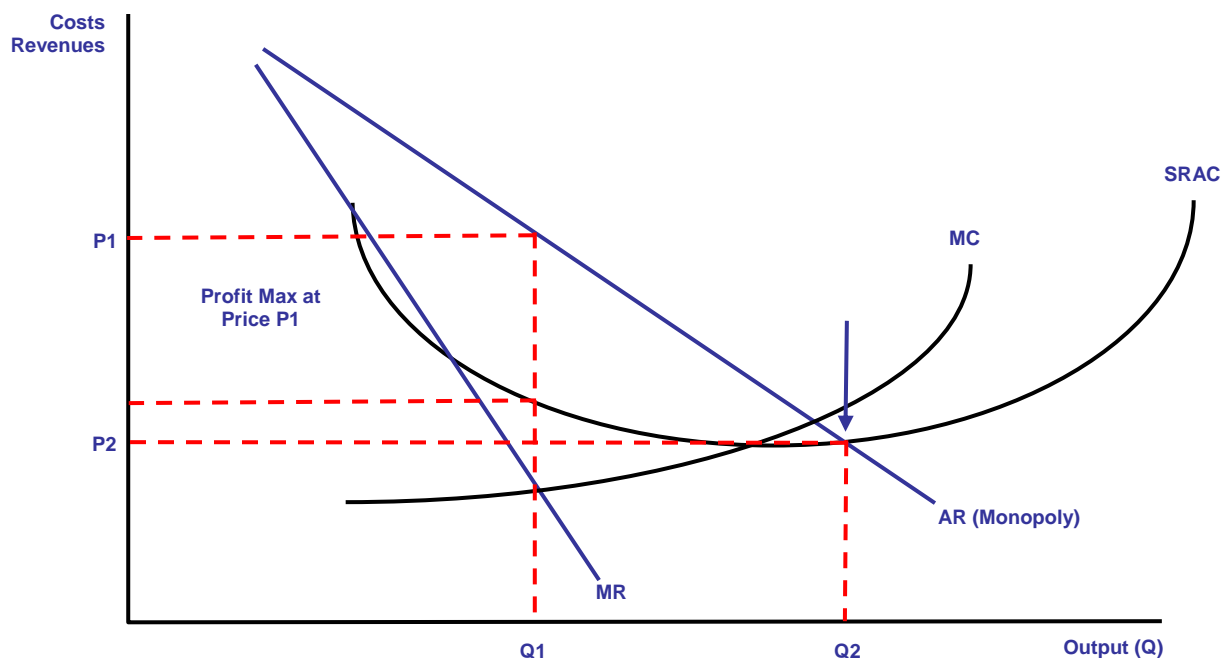
The impact of new technology is having a huge effect, not least because it have brought down some of the entry costs in some markets (leading to an increase in capital mobility). The rapid expansion of **e-commerce** for example has lead to the emergence of new players in the travel sector and online bookselling, insurance and many other markets. **Technological spill-over** can lead to the development of rival products that copy or imitate the characteristics of the products of the incumbent firms. Just a few years after the launch of Viagra, the anti-impotence drug, Levitra, the first market rival to the hugely profitable Viagra, is now being manufactured by the German firm, Bayer AG, and marketed by the British firm GlaxoSmithKline (GSK).

¹ Energy Watch is responsible for monitoring competition and prices in the increasingly competitive market and gas and electricity supplies <http://www.energywatch.org.uk/index.asp> Post Watch performs a similar function in the market for business and household postal services <http://www.postwatch.co.uk/index2.html>

² Telephone firm declares war on British Telecom <http://news.bbc.co.uk/1/hi/business/3555135.stm>
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Contestable Markets and the Performance and Conduct of Businesses

How might the contestability of a market affect the conduct and performance of businesses? It is worth emphasising in essays and data questions that it is the **actual behaviour of agents** in the market that is more important than a simple picture of market share.



In the diagram above a pure monopoly might price at P_1 and reach a profit maximising equilibrium. If a market is contestable, there is **downward pressure on price**, because the existence of supernormal profits provides a signal for new firms to enter the market and if the existing monopolist is producing at too high a price or has allowed their average total costs to drift higher, then entrants can undercut the monopolist and some of the monopoly profit will be competed away. Normal profit equilibrium occurs when average revenue equals average total cost (at output Q_2 and price P_2).

From an economic welfare point of view, a lower price and higher output implies an improvement in consumer welfare (which could be illustrated by an increase in consumer surplus).

When markets are genuinely contestable – we expect to see lower profit margins (i.e. lower “mark-ups”) than when a monopoly operates without competition. Indeed the threat of competition may be just as powerful an influence on the behaviour of the existing firms in a market than the actual entry of new businesses. If a dominant firm in a contestable market knows that new suppliers may come in – this may be sufficient for them to charge a price closer to the level we might expect from a competitive market structure.

If a market is contestable, industry structure and firm behaviour is determined by the threat of competition - 'hit-and-run' entry. The market will resemble perfect competition, regardless of the number of firms, since incumbents behave as if there were intense competition.

Key revision points:

- Be familiar with the barriers to entry and exit that might exist in any given industry

- Understand how the threat of competition can affect current price and output decisions of firms within a contestable market
- Understand that market share is not a reliable guide to market contestability. We need much more detail on aspects such as price elasticity of demand, the costs of suppliers etc
- Be aware that the UK and Competition Authorities are increasingly turning their attention to the determinants of market contestability rather than a narrow focus on market share and the profitability of businesses. The emphasis of government competition policy is mainly towards opening-up markets and encouraging the entry of new suppliers (both domestic and international)